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DHI CANADA – ECONOMIC FORECAST REVIEW
AUGUST 2017

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GOVERNMENT

Government Policy

Monetary policy at the federal level has caused a rise in interest rates for the first time in seven years. On July 12, the Bank of Canada increased its overnight lending rate by a quarter basis point to 0.75% and may boost it again in September or October 2017. In spite of the fact that the US Federal Reserve Board's rate currently sits between 1.00% and 1.25% and further rate hikes this year have been signalled by the Fed, the Bank of Canada's action has caused a run-up in the value of the Canadian dollar from a low of US$0.73 this spring to the recent four-year high of just over US$0.80 (this was in line with the RBC projection reported in our 2016 forecast). If the relatively high value of the Canadian dollar is maintained, it could cause a softening in export markets. However, there are indications that the Fed will be increasing its rate again in the next two years (three times in 2018 and three times in 2019), potentially giving a year-end 2019 rate in the range of 3.75% to 4.00%, assuming a quarter basis point increase each time. Unless this is matched by the Bank of Canada, it is likely that the Canadian dollar will retreat from current levels. In any case, most pundits feel that the dollar will not rise significantly from its current value.

Inflation remains slightly below 2.0%, which is within the government's target range of 1.0% to 3.0%, so there is little likelihood that Canadian interest rates will need to be used to affect inflation. Although inflation was recently described as "soft" by the Bank of Canada (meaning it has been trending slightly downwards, towards the 1.0% level and away from the ideal rate of 2.0%), it does not see this as a serious trend and therefore would not soon reduce the overnight rate. The Bank has previously said it would reduce interest rates if inflation consistently trended to or below 1.0%.

The Canadian and US interest rate hikes indicate the central banks feel that the countries' economies are recovering well and will sustain that growth, so economic stimulus through low interest rates is not necessary at this time. The US Fed is also partially unwinding its balance sheet, which currently contains about US$4.5 trillion dollars' worth of treasury and mortgage bonds which it purchased during the financial crisis to bolster economic growth – another indication of confidence in the economy.

In a nutshell, then:

- The Bank of Canada has recently increased its overnight lending rate to 0.75%
- There is a reasonable possibility of another increase in September or October
- The rate increase has boosted the value of the Canadian dollar
  - This may cause a short term weakening in export markets
  - The current US$0.80 value of the Canadian dollar likely represents close to the high water mark for the currency
- Although inflation in Canada has decreased to an average of 1.4% in Q1 of 2017 (below the 2.0% target), the Bank of Canada does not currently feel this is significant enough for it to moderate interest rate policy
- The US Fed is indicating its bank rate (currently between 1.00% and 1.25%) will increase once more this year and three times in both 2018 and 2019
  - Unless matched by the Bank of Canada, this will probably cause a decrease in value of the Canadian dollar over the same period
  - The Fed is also unwinding its balance sheet to dispose of some of the bonds purchased in the depths of the financial crisis, indicating its belief that US economic growth will remain strong.

Budgets

The Government of Canada's 2017 budget infrastructure spending focused on transportation and the electrical grid, and included relatively small amounts for tourism (mostly for promotion) and $1 billion for an infrastructure bank.

The Government of Ontario's 2017 budget includes an additional $30 billion in infrastructure spending over the 11 year period starting in in 2017-18. This money will go for priority projects such as roads, bridges, public transit, hospitals and schools; spending on new hospital projects, including three new hospitals and additional investment in two existing hospitals, is expected to be an additional $9 billion over 10 years. Ontario is also committed to redeveloping 30,000 long-term care beds for seniors by 2025. In education, the province is adding $16 billion over ten years for new schools and improving the conditions in existing schools.

The Government of BC's February 2017 budget included $2.7 billion in health capital projects and $2 billion in school capital projects over three years. It remains to be seen whether these commitments will be honoured by the new BC government.

The Government of Alberta's 2017 budget includes $500 million in capital spending for schools in 2017 and a further $488 million in 2018. The government is also committing to spending $4.5 billion in health care, including $400 million for a new hospital in Edmonton.

The Government of Quebec is committing to an additional $1.1 billion in school infrastructure spending in 2017-18.

ECONOMY

International Economic Outlook

The **Bank of Canada** (July 2017 Monetary Policy Report) reports that:

- Global economic growth is expected to reach 3.4% in 2017 and remain at that level through 2019
- US economic growth is expected to be moderate, at 2.2% in 2017, 2.1% in 2018 and 1.8% in 2019
- Growth in China's economy is expected to be 6.6% in 2017, declining to 6.3% in 2019
- Growth in oil-importing emerging market economies (e.g. Brazil) is expected to be 4.0% in 2017 and 2018, increasing to 4.2% in 2019
- Euro area growth is expected to be 1.9% in 2017, declining to 1.5% by 2019
- Uncertainty over future US trade policy presents a downside risk to the global projection, although the extent to which it could affect the projection is unknown at present

TD Economics reported similar international growth scenarios on June 15, and identifies some additional risks:

- As inflation returns to target levels (the result of excess economic slack[1] being absorbed), central banks will ease their monetary stimulus and begin raising interest rates. This accounts for declining increases in economic growth in 2018 and 2019
- Economic slack is expected to be absorbed (i.e. the economy will move closer to full utilization) over the next six quarters in Canada, the US and the euro area, so inflation will move closer to targets set by the various central banks
- Downside risks to the forecasts are the future of Brexit negotiations and what type of trade agreement will replace the UK's participation in the euro area; the potential for Italy to leave the euro if a populist government is elected; undercapitalized banking systems; Greek debt negotiations; and a potential derailing of the Trump administration's tax reform initiative
- The US debt ceiling needs to be raised or the government could face a shut-down and the risk of default on its obligations, forcing up US interest rates faster than the Fed currently plans and weakening economic and employment growth
    - On July 28 (the original deadline to raise the ceiling before Congress goes on its August break), the Secretary of the Treasury wrote to the Congressional leadership saying that this deadline was extended to September 29; after that time, the Treasury will be unable to meet upcoming payments
    - Most pundits think that the risk of missing that deadline is low, but there are obstacles to a resolution on this issue: the Treasury Secretary wants a "clean" bill raising the ceiling, while some Republican hardliners are looking to attach spending restrictions to the bill
- Of interest to DHI members, growth in US investment in non-residential structures is forecast to be 10.6% in 2017, falling to only 3.9% in 2018. The 2017 growth is a result of a Q1 2017 increase (over Q4 2016) of 28.3% in this sector (mostly attributable to an increase in the number of oil

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[1] Economic slack is the difference between current capacity utilization in the economy and theoretical full capacity. The normal measures for this are unemployment and wage growth. If unemployment is above what is considered to be "full employment" (which is "frictional unemployment" – those who are in the process of moving from one job to another and who therefore are not long-term unemployed – **not** zero unemployment) and wage growth is low, it shows that the economy is not operating at full capacity. Full capacity is characterized by low unemployment and higher wage growth as employers must increase wages to attract employees. Economic slack is also usually characterized by lower than expected inflation, as is currently the case in Canada, the US and many other economies.

rigs in production); the TD expects quarter-over-quarter growth to moderate significantly by Q4 to 2.7% (although this still outperforms the Q4 forecast of 2.0% for the economy as a whole)

- Interestingly, US imports are expected to increase their growth pace from 1.1% in 2016 to 6.0% in 2018 – this in spite of the Trump administration's focus on what appear to be protectionist trade measures such as the proposed "modernization" of NAFTA. **RBC Economics** theorizes this accelerated growth is a result of a relatively strong US dollar

Canadian Economic Outlook

- The **Bank of Canada**:
    - The Bank is forecasting real economic growth of 2.8% in 2017, 2.0% in 2018 and 1.6% in 2019. For the entire period, consumer spending is expected to be the major driver, contributing between 67% (2017) and 63% (2019) of all annual economic growth
    - Inflation is again forecast to hover around the 2.0% target by mid-2018 after some early "weakness" and be well within the target range of 1.0% to 3.0%. The bank is not anticipating any corrective action will be necessary at this point
- **TD Economics:**
    - 2017 GDP growth is expected to be 2.8% (same as the Bank of Canada), while 2018 growth, at 1.9%, is slightly below the Bank of Canada's forecast
    - Investment in non-residential structures is forecast to decline 3.6% in 2017 after a 10.8% decline in 2018 before recovering to 2.8% growth in 2018
    - Consumer expenditure growth is projected to be 3.1% in 2017 (5.3% for durable goods – vehicles, houses, white goods, etc.), declining to 1.7% in 2018 (durable goods growth will decline to 1.5%, being responsible for much of the overall decline in consumer spending)
    - Exports are anticipated to grow by 1.7% in 2017 and 3.4% in 2018; this ties in well with the projected growth in US imports. However, this projection is contingent on the "new" NAFTA being very similar to the existing pact and is also sensitive to the relative value of Canadian and US currencies
    - TD did not project an increase in the Bank of Canada overnight lending rate until Q4, and this is reflected in its estimate of the value of the Canadian dollar, which they expect to trade in the US$0.76 to 0.78 range in 2017 and 2018. As we know, however, the Bank of Canada increased its rate at the beginning of Q3 and the value of the dollar has seen a considerable run-up since
    - Unemployment is expected to be 6.5% in 2017 and 2018, down from 7.0% in 2016, supporting the argument that economic slack is being taken up

Overall, the Canadian economic outlook is good for 2017 into 2018, changing to only fair in late 2018 into 2019. Investment in non-residential construction will not decline as precipitously in 2017 as it did in 2016, but will not move into growth mode until 2018. Governments generally are easing up on stimulus measures such as infrastructure spending and are constrained by promises (in most cases) to move to balanced budgets and, ultimately, budgetary surpluses, so their ability to intervene (if GDP growth slows faster than projected or the economy slips into recession) by increasing capital spending will be limited. The outlook for Canadian exports is sensitive to US trade policy and the value of the Canadian dollar so, while the current export projection is fairly rosy, more restrictive trade policies and/or an upside movement in the Canadian dollar could reduce the outlook.